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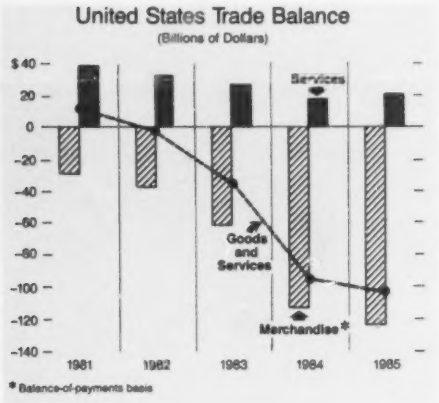
The Dollar and U.S. Trade



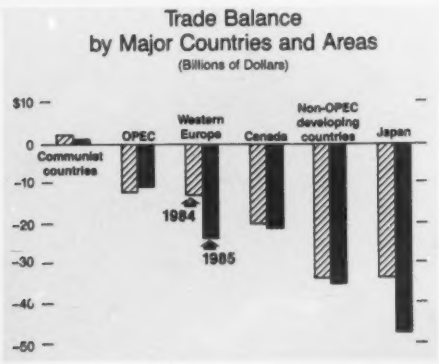
The U.S. dollar began to weaken against other major currencies in mid-March 1985. Its decline was given additional impetus by the late September meeting of the finance ministers of the five major industrial countries (G-5), at which they agreed that "some further orderly appreciation of the main nondollar currencies. . . is desirable." The five countries also stated their readiness "to cooperate more closely to encourage this when to do so would be helpful."

The sharp drop in oil prices this past winter put additional pressure on the dollar, both because it portended lower inflation rates and because the major oil-importing countries required fewer dollars to pay for oil imports. Overall, in the twelve months to mid-March of this year the dollar fell by 22 percent on a trade-weighted basis, i.e., against a composite of 15 other major currencies, and by 33 percent against the German mark and 32 percent against the Japanese yen.

At the same time, however, the foreign trade position and the overall balance of payments of the United States have shown no improvement. In fact, on both counts the 1985 performance was the worst on record. The merchandise trade deficit rose to $124 billion from $114 billion in 1984, while the deficit on goods and services (the broadest measure of the transfer of real resources between this country and the rest of the world) rose from $96 billion to $103 billion. The even more comprehensive current-account deficit—which measures the change in this country's international financial position—rose from $107 billion to $118 billion.

The rise in the 1985 trade deficit affected all merchandise categories, except petroleum, and all areas of the world, except OPEC. However, the different sectors and the various geographic areas shared unevenly in the deterioration of the U.S. trade position, especially when viewed over a five-year period.

The J-Curve Effect



Why have the U.S. trade and payments accounts not responded to the marked decline in the dollar? The relationship between changes in a country's exchange rate and its economy is complex at best. Exchange-rate movements, one student of the foreign exchange market has written, "bring about a chain of decisions by producers, consumers, and investors on whether to purchase foreign or domestic goods and whether to invest at home or abroad."

But generally there is a much simpler phenomenon at work: In the initial stages of a marked change in a country's exchange rate, the volume of both exports and imports fails to respond to that change. As a result, a trade deficit initially may become larger, even though the exchange rate has depreciated. This is what economists call the J-curve—an initial worsening followed, eventually, by an improvement. In other words, prices of exports and imports change more quickly than their volume, so that the value of exports may remain flat or even decline, while imports (priced in foreign currencies) would increase.

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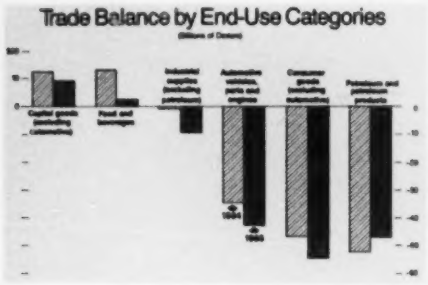
Special Factors at Work



Percentage Contributions to $137 Billion Deterioration in U.S. Non-Oil Trade Balance, 1980-85

By area: Africa, Australia and oceania	-0.7%
Canada	7.6
Western Hemisphere	12.7
Asia (excl. Japan)	22.4
Japan	26.4
Europe	31.6
	100.0
By major categories:	
Transportation equipment (excl. automotive)	2.5%
Chemicals	3.4
Crude materials	5.1
Agricultural commodities	11.3
Automotive vehicles	16.3
Miscellaneous products	16.4
Manufactures (excl. transportation and machinery)	16.7
Machinery	28.3
	100.0

The Dollar and Major Trading Partners

In the case of the United States, however, the trade picture is considerably more complex than can be explained in terms of exchange-rate relationships alone. Over the past few years, a good part of the deterioration in the U.S. trade position—some estimates put it as high as 50 percent—has reflected differences in the rates of economic growth between the United States and the other major industrial countries, the debt situation and hence the reduced import capacity of our major Latin American markets, and the greatly reduced financial clout and import potential of OPEC.

In the three years following the 1981-1982 recession (1983-85), the U.S. economy grew by 12.5 percent in real terms, compared with 5.5 percent for Western Europe. In addition, the onset of the economic recovery in the United States preceded the upturn in the other countries by approximately six months.

The Latin American debt crisis also had a pronounced effect on U.S. exports. Between 1978 and 1981, U.S. exports to Latin America had grown more than 50 percent faster than U.S. exports to the rest of the world, so that the declines of the early 1980's had a marked impact on overall U.S. export performance. The nearly $9 billion drop in U.S. sales to Latin America in 1982 accounted for over 40 percent of the total U.S. export decline that year. The 1983 drop of $7.4 billion was almost two-thirds of the total export decline of $11.7 billion. In both years, moreover, Latin America's imports from the United States fell faster than the decline in the area's imports from the world as a whole. (It should be noted that, following a further slight deterioration in 1984, the U.S. trade deficit with Latin America improved marginally last year, partly as a result of the major debtors' readjustment programs.)

OPEC's current-account balance declined from a record $110 billion surplus in 1980 to a deficit of $10-15 billion last year, as OPEC output came to account for an increasingly smaller share of total world oil production and as oil prices began to decline. While there are obvious differences in the financial positions of the various OPEC members (the so-called "low" and "high" absorbers), these developments affected overall OPEC purchases from the rest of the world. U.S. exports to that group fell from $16.9 billion in 1983 to $12.3 billion last year.

Another important aspect of the U.S. trade picture is the lack of any clearcut relationship between movements in the dollar and U.S. trade with individual countries. First, the largest bilateral deficits have not necessarily corresponded to exchange-rate movements vis-a-vis those countries. Second, much of our trade has been with countries whose exchange rates have moved little or even appreciated relative to the dollar over the past few years. In other words, a more detailed analysis of the geographic structure of the U.S. trade deficit during 1983-85 weakens the argument that the strength of the dollar was the major factor in our worsening trade performance.

Thus, Japan was the biggest single contributor to our global $300 billion deficit of those three years, its share amounting to $100 billion or one third. Yet, the dollar rose by only 7 percent against the yen during 1983-84 and then declined by 5 percent last year. (The corresponding relationships for Canada and Germany show even greater divergence.) Evidently, the dollar's strength had little to do with our huge trade deficit with Japan.

Exchange Rate Changes and U.S. Trade Shares

	Change in dollar rate, Feb. 1985 to Feb. 1986
South Africa	- 1.0%
Taiwan	- 0.3
Hong Kong	- 0.1
Canada	+ 2.6
Australia	+ 0.3
Korea	+ 4.9
China	+ 13.2
Philippines	+ 25.3
Chile	+ 38.5
Israel	+ 94.3
Mexico	+ 96.4
Brazil	+ 242.4

	U.S. exports (1985)	U.S. imports (1985)
South Africa	0.5%	0.6%
Taiwan	2.1	5.0
Hong Kong	1.3	5.0
Canada	22.4	19.3
Australia	2.5	0.8
Korea	2.8	2.9
China	1.7	1.2
Philippines	0.6	0.7
Chile	0.3	0.2
Israel	1.2	0.6
Mexico	6.4	5.3
Brazil	1.4	2.3
	43.2	41.4

Rather, Japan's trade surplus—not only with the United States, but with the rest of the world as well—is more a reflection of import barriers, relatively low domestic consumption, and superior product quality. (This is not to say that the United States is completely blameless in this matter. In an analysis of the U.S.-Japanese trade imbalance, the Committee for Economic Development last October cited "unbalanced macroeconomic policies" as well as "the inadequate performance by some components of the private sector" in both countries.)

The sharp drop in the price of oil—which in 1985 accounted for 31 percent of Japan's total import bill—will only tend to perpetuate, if not increase, that country's surplus. This year alone, Japan is expected to save an estimated $15 billion on its oil import bill. There has even been talk of Japan's becoming the "new OPEC" of the late 1980's, accumulating sizable external surpluses as oil prices decline further, but spending little of the additional savings abroad.

One further comment on the U.S.-Japanese trade relationship: Given the vast institutional and cultural differences between the two countries and their vastly different trade structures, completely balanced trade with Japan is not an objective that the United States can sensibly pursue. A recent study by the Washington-based Institute for International Economics has estimated what the bilateral trade deficit would have been if the U.S. budget deficit had not driven up both domestic interest rates and the dollar. The study finds that between 1980 and 1984 U.S. exports to Japan would have risen by more than 50 percent (instead of 12) and imports from Japan would have increased by only 50 percent (instead of 80). That still would have left a 1984 trade deficit of $23 billion, as against the actual $37 billion.

Second, the dollar's decline has been most marked vis-a-vis the European currencies and the yen—which eventually will help U.S. producers compete with Japanese and European exporters in third markets. Yet, a lower dollar has little impact on a dozen or so countries that account for over 40 percent of total U.S. trade, but against whose currencies the dollar either held its own or substantially appreciated in 1985.

The Role of Economic Policy

Some observers predict a further decline of 10 to 15 percent for the dollar in 1986, an amount considered necessary "to achieve a lasting balance" in our external accounts. But in view of the various factors mentioned here, such an improvement may be longer in coming and at the same time less marked than is generally hoped for.

Moreover, a reduction in the U.S. trade deficit cannot be achieved at the expense of the developing countries. As Morgan Guaranty put it recently, "Just as much U.S. government spending is off limits to budget cutters, many of the most significant U.S. trade partners either are in no financial position or are otherwise implausible candidates to cut back their sales to the United States."

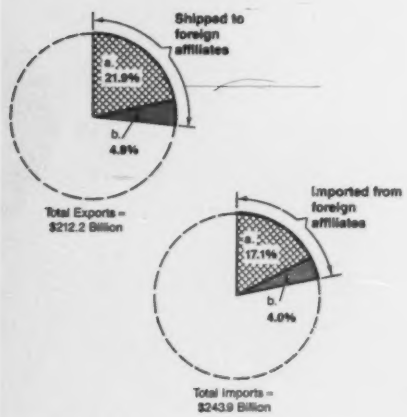
This means that most of the improvement in the U.S. trade position has to come vis-a-vis those countries that can most afford to reduce their own external surpluses. But when the imbalances, both domestic and international, have been allowed to get as large as they have over recent years, the necessary corrections, both in exchange rates and relative growth rates, may have to be substantial.

The United States appears to be living up to its responsibilities in this regard by recognizing the need to reduce its budget deficit and by adopting a more constructive and more realistic view of the role of exchange rates. But the needed corrections cannot be made by the United States alone; Europe has to play a major role as well. One would hope that the improved economic outlook and the heightened sense of optimism that prevail in Europe at this point will enable the European authorities to go for a somewhat more expansionary policy stance—which means to become more tolerant of some deterioration in their own comfortable external positions.

How Much Trade Is "Foreign" Today?

The entire debate over the U.S. trade performance tends to ignore one major development: In an increasingly internationalized and interdependent world economy the distinction between U.S. and foreign products is rapidly blurring. For example, over one third of total trade between the United States and Canada consists of automotive products moving between U.S. manufacturers and their Canadian subsidiaries. Again, the U.S. trade deficit with Taiwan was the third largest (after Canada and Japan) in both 1984 and 1985. Yet, four of the ten largest Taiwanese exporters are subsidiaries of U.S.-based companies, including such giants as RCA and Texas Instruments.

U.S. Trade with U.S. Companies' Foreign Affiliates, 1982



a. By U.S. parents
b. By other U.S. sources

In fact, an increasing share of U.S. trade takes place with the overseas affiliates of U.S. multinationals. In 1982, the year of the Commerce Department's latest benchmark survey of U.S. direct investment abroad, U.S. trade with such affiliates accounted for 26.7 percent of total exports and 21.1 percent of total imports. For trade between U.S. parents and their affiliates, the shares were 21.9 percent and 17.1 percent, respectively. For trade in manufactures alone, the ratios were roughly similar.

There is another dimension to the question of what constitutes trade or more properly "unfair" trade. This arises in connection with antidumping complaints filed by U.S. firms with the International Trade Commission (ITC). For instance, can the U.S. semiconductor industry claim to be injured by Japanese imports when many of the components it uses come from Japan? Or can a manufacturer who uses imported Brazilian steel which he rolls into pipes complain against imports of Brazilian steel pipe? On these and related aspects, both world trade law and, increasingly, the meaning of foreign-trade statistics don't seem to fit any longer the way in which U.S. companies do business.

As ITC chairwoman Paula Stern puts it: "It is possible that our laws, which are based on certain assumptions as to what 'U.S. industry' is, don't address the reality of the marketplace." This seems to become increasingly true for our trade statistics and hence for the perception of what our trade balance is and what it ideally ought to be as well.

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